

Number: **201019008**
Release Date: 5/14/2010
Index Number: 61.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact: _____, ID No. _____

Telephone Number:

Refer Reply To:
CC:ITA:B05
PLR-138149-09
Date: February 1, 2010

Legend:

Taxpayer =

Partnership =

Development Company =

Fund =

Project =

Owner =

\$ Amount 1 =

\$ Amount 2 =

\$ Amount 3 =

Dear _____ :

This is in reply to your request for a private letter ruling that in the proposed transaction Taxpayer will in substance enter into a management contract for federal income tax purposes and that certain amounts collected under the management

contract will not be included in the gross income of Taxpayer pursuant to § 61 of the Internal Revenue Code (the Code).

FACTS:

I. General

Fund intends to provide retail and service facilities as part of Project. Partnership and related entities, including Taxpayer and Development Company, specialize in the design, construction, and management of open-air lifestyle centers, mixed-use projects, neighborhood retail shopping centers, and single tenant build-to-suits.

With other parties, Taxpayer, Development Company, and Fund will enter into a venture agreement under which (i) Fund will construct, with construction management provided by Development Company, all of the buildings and associated improvements for the Project (the "Project Improvements"), (ii) Taxpayer will negotiate, enter into, and enforce tenant leases with third-party retailers approved by Fund, and (iii) Taxpayer will cause the management of the operation and maintenance of the Project Improvements by entering into a property management agreement with a Property Manager and enforcing the terms of the agreement.

Taxpayer will enter into a ground lease with Owner, for which it will pay \$ Amount 1 per year. This amount will be reimbursed by Fund. Under the ground lease, Fund will have the right to construct Project Improvements and to use and license the Project Improvements to Taxpayer. Fund will retain title to the Project Improvements during the term of the ground lease, and will transfer title to the Project Improvements to Owner following the expiration of the ground lease.

The ground lease provides that Taxpayer is to obtain liability insurance, standard fire, and extended coverage insurance, with Fund as the beneficiary. The cost of insurance will be reimbursed to Taxpayer as an Approved Operating Expense (defined below). Alternatively, Fund may purchase the insurance directly or self insure.

Taxpayer is designated to enter into tenant leases. Both the tenant and the form of the lease must be approved by Fund. Taxpayer will implement, at the written direction of Fund, any decisions made by Fund in connection with the operation of Project Improvements or any policies or procedures relating thereto, including retail occupancy activities.

Taxpayer will enter into an agreement with a Property Manager to provide for the operation and maintenance of Project Improvements. Duties include, but are not limited to, (i) causing Project Improvements to be maintained, (ii) conducting regular periodic inspections of the Project Improvements, and (iii) handling all complaints and requests regarding the Project Improvements. Fund will have the right to approve the Property

Manager. Further, Fund will have the right to terminate the agreement with the Property Manager, upon 30 days' notice. All acts performed by the Property Manager in the performance of its obligations under the agreement will be performed as an agent of Taxpayer.

Following completion of construction, Fund will pay Taxpayer an annual fee of \$ Amount 2 if the Property Manager is related to Taxpayer or \$ Amount 3 if the Property Manager is not related to Taxpayer.

II. Collection Account

The Property Manager will collect or receive all payments made by tenants and required under tenant leases. All amounts collected by the Property Manager will be deposited in a local depository account (the "Collection Account.") The Fund will be the sole authorized signatory for the Collection Account.

In addition to payments collected under the tenant leases, the Property Manager must use good-faith efforts to qualify to collect or receive fees, profits, rebates, or other value in connection with providing supplies, equipment, materials, and services procured in the maintenance and operation of the Project Improvements. The Property Manager will deposit these into the Collection Account upon receipt. Any amounts deposited shall inure and belong to Fund.

III. Financial Reporting

On or before 120 days following the end of each fiscal year, Taxpayer will make and distribute, or cause to be made and distributed, to Fund a financial statement showing the operations of Taxpayer with respect to the Project Improvements. All accounts and records relating to the Project Improvements, including all correspondence, will be surrendered to Fund upon written demand without charge.

The Property Manager must provide Fund and Taxpayer with a monthly statement of receipts and disbursements from the operation of the Project Improvements from the prior month. The Property Manager will prepare and submit to Fund and Taxpayer other monthly reports including, but not limited to, a monthly occupancy report for the Project Improvements, monthly capital expenditures, monthly maintenance reports, and monthly operating statements. Finally, within 90 days after the end of each calendar year, the Property Manager will deliver to Fund and Taxpayer a profit and loss statement showing the results of the Project Improvements for that year and a balance sheet for Project Improvements as of the end of the year.

IV. Reimbursement

The Property Manager will pay, or cause to be paid, all expenses of the Project Improvements including, without exception, the Approved Operating Expenses and Extraordinary Operating Expenses. These expenses, described below, will be paid out of an account that the Property Manager establishes for this purpose.

For the Approved Operating Expenses, Taxpayer will prepare an annual operating budget for operation and maintenance of Project Improvements. Items in the budget include concession fees, property management fees, operating and maintenance expenses, and any obligations of the Taxpayer to make payments under the Ground Lease.

Fund initially will transfer to Property Manager an amount equal to three months of the annual budget. The Property Manager will use this reserve to pay Approved Operating Expenses to the extent amounts in a separate operating account are insufficient. To the extent reserve funds are used, they will be replenished by a lockbox agent or trustee. If the Property Manager has insufficient funds to pay expenses relating to Project Improvements, the Property Manager will request additional funds from Taxpayer and Fund. The Property Manager and Taxpayer have no duty to advance funds on behalf of Fund. Fund is ultimately responsible for paying all Approved Operating Expenses and all Extraordinary Operating Expenses.

In addition to Approved Operating Expenses, Fund will pay to the Property Manager the Extraordinary Operating Expenses. Extraordinary Operating Expenses include (i) all reasonable and necessary improvements of the Project Improvements that are related to unusual, nonrecurring, and unanticipated circumstances, (ii) costs, expenses, or liabilities incurred by Taxpayer or Development Company relating to the construction, use, operation, management, or possession of the Project Improvements (except to the extent resulting from negligence or willful misconduct or breach of an express obligation by Development Company or Taxpayer), (iii) Taxpayer's indemnification obligation under the property management agreement, and (iv) Taxpayer's indemnification obligation under the ground lease.

V. Indemnification

The ground lease provides that Taxpayer will indemnify and hold harmless the Owner from any and all damages to property or persons on the premises of the Project Improvements that are not due to the fault or negligence of the Owner or its contractors. Payments made by Taxpayer under this indemnification provision will be reimbursed to Taxpayer as an Extraordinary Operating Expense.

Fund will indemnify and hold harmless Development Company and Taxpayer from suits, claims, judgments, and expenses incident thereto arising from (i) violation or infringement of third party patents, trademarks, or copyrights by Fund, (ii) items or services negligently provided by Fund unless the harm resulted from acts or omissions

of Development Company or Taxpayer, (iii) other negligent or willful acts or omissions of Fund in connection with performance under the venture agreement, or (iv) any actual or alleged violation or inaccuracy of any representation or warranty of Fund contained in the venture agreement.

LAW AND ANALYSIS:

Section 61(a) generally provides that gross income includes all income from whatever source derived, including (but not limited to) compensation for services and rents. In general, rents collected under a lease are income to the lessor. However, while Taxpayer is the nominal lessor under retail leases with tenants in the Project, Taxpayer contends that the agreements it has entered into constitute a contract for management of the Project and that amounts collected from tenants or others and deposited in a Collection Account are not includible in its gross income, but are collected on behalf of Fund.

Courts have long held that the substance of an agreement rather than its form determines its true character as a management contract, lease, or other arrangement. *Amerco v. Commissioner*, 82 T.C. 654 (1984); *Kingsbury v. Commissioner*, 65 T.C. 1068 (1976), *acq.* 1976-2 C.B. 2. According to the Tax Court, the two primary factors that indicate the existence of a management contract are (1) the control of a venture by the property owner and (2) risk of loss borne by the property owner. *Amerco*, 82 T.C. at 670; *Freesen v. Commissioner*, 84 T.C. 920 (1985), *rev'd on other grounds*, 798 F.2d 195 (7th Cir. 1986); *Meagher v. Commissioner*, T.C. Memo 1977-270.

In *Meagher v. Commissioner*, T.C. Memo 1977-270, the taxpayers owned a railroad tank car and entered into a “management contract” with a management company. Pursuant to the management contract, the management company agreed to perform all administrative functions necessary to operate the car (including collecting the mileage or per diem earnings), to repair and maintain the car, to keep records of the car’s operation, to insure the car, and to use its “best efforts” to lease the car to shippers, railroads, or others. The taxpayers agreed to pay the management company a quarterly fee equal to 35 percent of the gross operating profit earned by the car and to defend and hold harmless the management company from any loss or damage to the car. The court concluded that the contract was more properly characterized as a management contract and not a lease because the owners of the car retained control over the venture and had the risk of loss with respect to the property.

Concerning the control factor, the Tax Court in *Meagher* found that, although the taxpayers did not directly control the leasing activities of the management company, they did insert provisions in the agreement requiring the management company to keep adequate records of the car’s operation, to use its best efforts to lease the car, to obtain insurance coverage for the car naming the taxpayers as co-beneficiaries, and to pay the

net earnings of the car to taxpayers within ninety days after the end of the calendar quarter. The court found that such provisions provided the taxpayers with sufficient control over the venture to support a conclusion that the agreement was a management contract.

Concerning the risk of loss factor, the court noted that the taxpayers agreed to reimburse the management company upon demand for any expenses incurred in excess of a \$200 reserve and to defend, indemnify, and hold the management company harmless from and against all risk of loss or damage to the tank car as well as all claims, damage, expenses, or liabilities incurred by, or asserted against the management company, as a result of the operation, possession, control, or use of the tank car. Consequently, the court also found that the taxpayers' risk of loss was sufficient to support a finding that the transaction was a management contract.

An analysis of the above factors indicates that, under the agreements, Fund retains sufficient control and risk of loss with respect to the Project so that Taxpayer's status is that of a property manager who collects rents and other amounts on behalf of the owner of the property, rather than a lessee of the property who collects sublease rents. Therefore, amounts (i) due under tenant leases or otherwise collected by the Property Manager and (ii) deposited into the Collection Account under the circumstances described in this ruling will not be included in the gross income of Taxpayer.

Concerning the control factor, certain provisions of the venture agreement indicate that Fund will retain control of the Project Improvements and their operation. The provisions require that the form of the tenant leases and the tenants themselves be approved by Fund. Taxpayer will, at the written direction of Fund, implement any decisions made by Fund in connection with the operation of the Project Improvements. Fund has the right to approve the selection of the Property Manager and may replace the Property Manager.

The Property Manager will collect amounts related to Project Improvements and deposit them in the Collection Account. Fund will be the sole authorized signatory of the collection account. In addition to payments collected under the tenant leases, the Property Manager must use good-faith efforts to qualify to collect or receive fees, profits, rebates, or other value in connection with providing supplies, equipment, materials, and services procured in the maintenance and operation of the Project Improvements. These amounts as well will be placed in the Collection Account.

Taxpayer will prepare or cause to be prepared a draft annual operating budget, which must be approved by Fund. Taxpayer will make or cause to be made a financial statement in regards to the Project Improvements and distribute this to Fund. Fund may demand any accounts or records relating to Project Improvements.

Taxpayer is to obtain liability insurance, standard fire, and extended coverage insurance, with Fund as the beneficiary. In this case, the purchase will be reimbursed to Taxpayer as an Approved Operating Expense. Alternately, Fund may purchase the insurance directly or self insure.

Concerning the risk of loss factor, Fund must reimburse and fund all operating expenses and also must indemnify Taxpayer for losses incident to the Project. The rents Fund collects from tenants through the Property Manager and Taxpayer may, or may not, equal these expenses and indemnification liabilities. Meanwhile, Taxpayer is merely collecting revenues from tenants on behalf of Fund. Taxpayer's income from the Project is a fixed fee. Fund, not Taxpayer, bears risk of loss from Project operations.

CONCLUSION:

Amounts (i) due under tenant leases or otherwise collected by the Property Manager and (ii) deposited into the Collection Account under the circumstances described in this ruling will not be included in the gross income of Taxpayer.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This ruling is conditioned upon the accuracy of that information and those representations. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative. A copy of this letter must be attached to any income tax return to which it is relevant.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,
John Aramburu
Senior Counsel
Branch 5
Office of Associate Chief Counsel
(Income Tax & Accounting)